D.T.E. 98-32-B

Investigation by the Department of Telecommunications and Energy upon its own motion commencing a Notice of Inquiry pursuant to 220 C.M.R. §§ 2.00 et seq. into the unbundling of all natural gas local distribution companies' services.

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I. INTRODUCTION

On July 18, 1997, the Department of Public Utilities, now the Department of Telecommunications and Energy ("Department"), directed the ten investor-owned natural gas local distribution companies ("LDCs") to initiate an industry-wide collaborative process to develop a common set of principles for the comprehensive unbundling of services of the Commonwealth's natural gas industry. In response to the Department's directives, nine LDCs[(1)] formed the Massachusetts Gas Unbundling Collaborative ("MGUC" or "Collaborative"). The tenth LDC, Bay State Gas Company, participated in the MGUC, while continuing its own initiative to produce a company-specific unbundling filing in the forum of the Bay State Collaborative.[(2)] Participants in the MGUC include marketers of natural gas and services, customer groups, government agencies, the Department, and the LDCs.

On March 18, 1998, the Collaborative filed its Report of the Massachusetts Gas Unbundling Collaborative ("MGUC Report"). The MGUC Report summarized the progress made by the MGUC since July 18, 1997. As described in the MGUC Report, the participants were able to reach a consensus on many important points but could not come to agreement on, inter alia, the disposition of capacity and any associated cost responsibility. As a result, the participants sought the Department's guidance on these unresolved issues (MGUC Report at 5). This Order addresses these residual questions.

On April 3, 1998, in response to the MGUC Report, the Department voted to issue a Notice of Inquiry ("NOI") regarding the unbundling of services offered by local gas distribution companies.[(3)] The NOI encompasses all issues associated with the restructuring of the natural gas industry, with a primary focus on issues pertaining to (1) capacity disposition, both upstream and downstream, and (2) associated cost responsibility. The Department docketed this matter as D.T.E. 98-32. In this Order, the

Department provides the necessary guidance to move toward comprehensive unbundling of all natural gas distribution companies' services.

II. PROCEDURAL HISTORY

On May 1, 1998, the Department received initial comments in response to the NOI from the following: Blackstone Gas Company, the Berkshire Gas Company, Boston Gas Company, Colonial Gas Company, Commonwealth Gas Company, Essex County Gas Company, Fall River Gas Company, Fitchburg Gas and Electric Light Company, and North Attleboro Gas Company (collectively, the"LDCs"); Bay State Gas Company ("Bay State"); the Attorney General of the Commonwealth, the Massachusetts Division of Energy Resources, the Associated Industries of Massachusetts, and The Energy Consortium (collectively, "Customer Group"); Commonwealth of Massachusetts Procurement Management Team; AllEnergy Marketing Company, LLC, The Eastern Group, EnergyEXPRESS, Energy Vision, Enron Energy Services, Global Petroleum Corp., the Market Access Coalition, PG&E Energy Services, Select Energy, Inc. and Utilicorp United, Inc. (collectively, "Marketer Group"); Amoco Energy Trading, Inc., and Duke Energy Trading, and Marketing LLC; Algonquin Gas Transmission Company, and Texas Eastern Transmission Company (collectively, "Duke Northeast Pipelines"); El Paso Energy Marketing ("El Paso"); Enron Capital & Trade Resources, Inc.; Imperial Oil Resources; Energy PMT Boston; Sithe Energies, Inc. ("Sithe"); and Tennessee Gas Pipeline Company ("Tennessee").

From May 15, 1998 through May 20, 1998, the Department conducted four days of hearings at its offices in Boston. The Department assembled panels of witnesses to address the following topics: (a) mandatory capacity assignment; (b) voluntary capacity assignment; (c) transition costs; (d) cost responsibility; (e) regulatory oversight; (f) downstream assets; (g) consumer education; (h) reliability; and (i) portfolio auction. The record includes responses to 21 record requests issued to various participants by the Department.

On June 8, 1998, the Department received final comments from the LDCs; Bay State; the Marketer Group; the Customer Group; Duke Northeast Pipelines; El Paso; Engage Energy US, L.P.; Massachusetts Senior Action; Sithe; Tennessee; and TransCanada Gas Services Limited.

On August 26, 1998, the Department issued supplemental questions to the participants regarding the effect on the NOI, if any, of the Federal Energy Regulatory Commission's ("FERC") proposed policy initiatives in RM98-10 and RM98-12.[4]

The LDCs, Bay State, the Customer Group, the Marketer Group, and Duke Energy, and Marketing LLC submitted responses on September 9, 1998.

III. DEPARTMENT GOALS

We previously have stated our overall goals for a competitive natural gas industry. The Department's goals are to: (1) provide the broadest possible customer choice; (2) provide all customers with an opportunity to share in the benefits of increased competition; (3) ensure full and fair competition in the gas supply market; (4) provide functional separation between sale of gas as a commodity and local distribution service; (5) support and further the goals of environmental regulation; and (6) rely on incentive regulation where a fully competitive market cannot exist, or does not yet exist. Letter from Department of Public Utilities (now Department of Telecommunications and Energy) at 2 (July 18, 1997). The Department notes that how and the extent to which we can achieve these goals may be enabled or limited by FERC actions.

In Electric Industry Restructuring Plan: Model Rules and Legislative Proposal, D.P.U. 96-100, at 1 (1996), the Department stated that our goal is to facilitate the smooth transition of the electric market from its current regulated monopoly to a competitive market framework better suited to the economic realities of the 21st century. The Department remains committed to its long standing goal to facilitate the transition of the natural gas market in Massachusetts from a regulated monopoly to competition wherever the market is capable of delivering enhanced benefits to the consumers in the form of broader choice, increased efficiency, and lower cost.

Economic regulation of utility service acts as a surrogate for the competitive market where market forces are insufficient to ensure the reliable allocation of resources at an efficient price. See Electric Industry Restructuring Plan: Model Rules and Legislative Proposal, D.P.U. 96-100, at 3-4 (1996); Boston Gas Company, D.P.U. 88-67 (Phase I), at 325-326 (1988); Gas Transportation Generic, D.P.U. 85-178, at 10 (1987); IntraLATA Competition, D.P.U. 1731, at 18 (1985). Where changed circumstances make reliance on the surrogate (regulation) no longer necessary, transition to reliance on more efficient market forces is both warranted and desirable. The Department has stated its firm commitment to move toward competitive markets as a means to achieve its regulatory goal of ensuring that utilities provide safe and reliable service at the lowest possible cost to society. See Electric Industry Restructuring, D.P.U. 95-30, at 1-2 (1995); Incentive Regulation, D.P.U. 94-158, at 4-7 (1995); Mergers and Acquisitions, D.P.U. 93-167-A at 21 (1994). The Department has also encouraged reliance on market forces in place of traditional regulation. Interruptible Transportation/Capacity Release, D.P.U. 93-141-A at 21 (1996); Boston Gas Company, D.P.U. 93-60, at 413 (1993).

In Electric Industry Restructuring Plan: Model Rules and Legislative Proposal, D.P.U. 96-100, at 10-11 (1996), the Department stated that in a restructured electric industry, generation services would become competitive, but acknowledged that competitive market forces could not yet substitute for regulatory oversight with regard to distribution and transmission services. Therefore, both of these services would continue to be subject to state and federal regulation.

Like the electric industry, the gas industry structure exhibits three main features: (1) local distribution; (2) interstate gas commodity; and (3) interstate gas transmission and storage (or upstream transportation and storage capacity). Local gas distribution service, considered a monopoly function by all of the commenters in this proceeding, is provided exclusively by local gas distribution companies. Congress and the FERC have deregulated the interstate gas commodity market. This deregulation has led to a workably competitive gas commodity market.

Interstate gas transmission brings gas commodity to the city gate[(5)] of the local distribution companies, which are responsible for the reliable delivery of the commodity to customers. The manner in which LDC transportation and storage capacity upstream of the city gate might be made available to migrating customers, the subject of debate in this inquiry, is inextricably linked to the LDCs' traditional obligation to serve and to their supply planning and procurement role. The current regulatory regime for the gas industry in Massachusetts is designed to ensure that reliable gas supply service is available to customers at the lowest cost achievable under such a regime. In addition, LDCs have traditionally had the obligation to plan for and procure sufficient upstream capacity to meet design year and design day standards and to ensure deliverability of gas under a range of supply contingencies on a cost-effective basis. We have acknowledged, however, that regulation has not always achieved its intended purpose or goals. New England Telephone, D.P.U. 94-50, at 104-105 (1995).

The Department envisions a fully competitive gas industry in which all customers would have the option to purchase both gas commodity and transportation capacity from a wide range of providers operating in a competitive market. In this fully competitive market for commodity and capacity, LDCs no longer would be required to serve as gas merchants to all customers downstream of the city gate but would be responsible only for the local distribution function. That is, the LDCs' obligations would be limited to the transportation and delivery of supplies brought to the city gate by competitive third-party suppliers. Under these circumstances, the LDCs' traditional obligation to procure and transport gas to all existing customers would have to be modified because, once removed from the merchant function, LDCs would no longer be in the position to ensure reliable and least-cost gas-sales service to distribution customers collectively.

A workably competitive upstream capacity market must exist in order to ensure the availability of reliable and reasonably priced capacity resources without regulatory oversight. Under this scenario, LDCs would have a diminishing role in selling gas commodity to customers because, increasingly, customers would elect to purchase the gas commodity from alternative suppliers. The LDCs would also assign their upstream capacity resources to competitive market participants on a permanent basis, because the LDCs would no longer require the capacity resources to serve their own customers. As LDCs exit the merchant function, their obligation to serve, other than for distribution, would be met by the competitive market.

However, as we explain in Section IV.A.6 below, the Department believes that the conditions precedent to a fully competitive market structure for interstate pipeline and storage capacity do not yet exist. Because the upstream capacity market is not workably competitive, the LDCs' obligation to serve cannot now be eliminated. Otherwise, Massachusetts would run the risk that interstate capacity could be diverted to serve markets outside the Commonwealth or other non-traditional customers within the state market, such as gas-fired electric generation facilities, and might not be available to serve existing customers. As a result, adequate levels of reliability might not be maintained and secure service could be jeopardized.

In the absence of a fully functioning, workably competitive market for upstream capacity, it would be premature for the Department to implement a capacity assignment system that would allow unregulated marketers to decide whether to elect, contract for, or maintain capacity. In contrast to the electric industry, no institution like the New England Power Pool or the Independent System Operator - New England exists, or is yet developing, to establish and enforce reliability criteria for marketers. As we indicate in section IV.A.6 below, the Department concludes that in order to ensure reliable gas deliveries at reasonable prices, the LDCs must, for the time being, retain the obligation to plan for and procure capacity resources during a transition period. The Department believes that a five year transition period, with an intervening evaluation of market conditions after three years, is appropriate. During this period, as the transition is made from the current, intensely regulated structure to a structure where the competitive marketplace can be relied upon for the provision of reliable, low-cost gas deliveries, our objective is to put in place a workable capacity allocation program. That program would facilitate a transportation program to provide migrating customers and their marketers with access to the interstate capacity resources needed to meet customers' requirements. The program would not jeopardize the ability of either the LDCs or marketers to provide reliable service to their customers.

The Department's actions affect only Massachusetts. Massachusetts lies at the very periphery of a much larger interstate gas transportation system over which the Department has no control and but limited influence. Actions yet to be taken by the FERC may accelerate or may slow the move towards more competitive capacity markets. The Department will, as it must, evaluate and respond to FERC actions.

To facilitate the transition to a competitive natural gas market, this order addresses the two issues that the Collaborative participants, thus far, were unable to resolve: (1) capacity assignment of upstream and downstream resources; and (2) cost responsibility. Our intent is also to ensure that: (1) customers in general are not made worse off by the transition to a workably competitive capacity market; and (2) the transition is orderly, expeditious and minimizes customer confusion. Massachusetts' gas load is and will remain weather sensitive. In addition, Massachusetts is located at the end of the pipeline and has historically been capacity-constrained. Therefore, reliability will continue to be an essential regulatory criterion against which all policy innovations are assessed. Deliberate progress toward capacity assignment will capture realistic benefits without incurring unreasonable risks for customers.

IV. CAPACITY ASSIGNMENT

A. Upstream Capacity

To meet their historical obligation to provide reliable, least-cost service to customers, LDCs have secured upstream pipeline and storage capacity to transport necessary gas supplies to their city gates. As customers of the LDCs migrate from sales to transportation service and contract for delivered gas supplies through independent third-party marketers, customers -- or marketers on their behalf -- must have access to this pipeline and storage capacity. The manner in which this capacity is made available to migrating customers will be a key issue in bringing the benefits of a competitive natural gas market to all customers.

Traditionally, the LDCs have entered into long-term capacity contracts with the various upstream pipelines to ensure that gas being purchased for peak-day needs would actually be delivered to the distribution company and, ultimately, to the distribution company's customers. Historically, the term for such contracts typically was twenty years. Recently, contract terms have shortened as a result of changes in interstate pipeline regulation at the federal level.[(6)] In New England, many of the existing twenty-year contracts are due for renewal or termination in the next two to ten years, making this an ideal time to evaluate the future role of these capacity contracts. We note that pipeline transportation charges remain subject to FERC regulation under which maximum rates are established.

Generally, each LDC has numerous capacity contracts on several upstream pipelines serving the area. These contracts are categorized as long-haul, short-haul, and storage. For example, excluding storage-related contracts, Boston Gas Company, the largest Massachusetts LDC, has approximately 35 contracts with seven different pipelines. The total annual cost of Boston Gas Company's contracts exceeds $100 million. By contrast, Fall River Gas Company has nine contracts on two pipelines with an annual cost of approximately $8 million (LDC Comments, Exhibit 1(b) and 1(f)). Until contracts like these expire, are terminated, or are assigned to a marketer, the LDCs have a contractual responsibility to pay fixed capacity costs to the pipelines on an annual basis. (Even upon assignment (i.e., delegation of performance obligations short of novation), contingent liability would probably persist.)

Collaborative parties have presented the Department with three alternative means by which marketers and other third-party suppliers might achieve access to an LDC's current portfolio of upstream capacity. These alternatives are: (1) mandatory assignment of the LDC's upstream capacity, (2) voluntary assignment of the LDC's upstream capacity, and (3) a hybrid proposal, by Bay State Gas Company, that combines elements of the mandatory and voluntary approaches. As noted in the comments and testimony presented by parties to this proceeding, a resolution of the upstream capacity issue requires consideration of several related matters, including competitiveness of the upstream market and cost responsibility for any unelected capacity contracts.

1. Mandatory Assignment

Under the proposed mandatory assignment method ("mandatory assignment"), a migrating customer[(7)] is assigned its pro rata share of the upstream pipeline and storage capacity used to provide bundled sales service to customers (Joint Comments of LDCs at

18). The pro rata share of capacity that is assigned to each customer is based on the customer's contribution to peak-day demand for gas (Tr.1, at 28). After the customer's pro rata share has been determined, the LDC will use historical information to determine which capacity contracts have been used to serve the migrating customer (id.). When the capacity is assigned, it is assigned at maximum tariffed rates, i.e., the local distribution company's annual cost (Joint Comments of LDCs at 18). Under mandatory assignment, migrating customers will retain the responsibility for the costs associated with the capacity procured and maintained by the local distribution company to provide traditional firm sales service (Joint Comments of LDCs at 18). As a result, all marketers assume the same cost structures with regard to the assigned capacity (id.). Under a mandatory capacity assignment regime, once the capacity is assigned to a customer's competitive supplier, the supplier will have the ability to re-market some or all of the capacity allocated to it and to serve its customers with any combination of resources that the supplier may hold (id.). Nine of the ten investor-owned LDCs[(8)] favor the mandatory capacity assignment method.

2. Voluntary Assignment

Under the proposed voluntary assignment method ("voluntary assignment"), each LDC first identifies the amount of pipeline capacity that it had secured in order to serve those customers for whom a marketer will supply the gas commodity (Joint Comments of LDCs at 22). The marketer would then select all or a portion of the pro rata share of the pipeline transportation capacity for which the LDC had contracted in order to serve those end users that migrated to commodity procurement by the marketer (Tr. 1, at 24).[(9)] The marketer would be permitted to choose the percentage (0-100%) of the identified capacity that it regards as necessary to provide service to its migrating customers and as to which it chooses to assume contractual responsibility from the LDC (Marketers Comments at 5). Marketers would likely vary in the portions of identified capacity that they select, with some marketers assuming all of their identified portions of capacity and others selecting less than their maximum portion (Customer Group Comments at 8, 10-11).

Voluntary assignment of upstream pipeline capacity permits each marketer to choose the amount of an LDC's capacity that the particular marketer needs in order to serve the gas purchase demands of those customers that the marketer has acquired from the LDC (Marketer Group Comments at 1). Under voluntary assignment, marketers would not incur immediate cost responsibility for unassumed LDC capacity (id. at 1, 5). To the extent that marketers do not select their full entitlement of the identified LDC capacity, the LDC's obligation for such unselected costs would be identified as "transition" costs, i.e., costs to make the transition to a competitive market (id. at 6). Unless accepted by the marketers or otherwise mitigated, such costs would be paid by the LDCs or by their customers as "stranded costs" (Joint Comments of LDCs at 24). According to Bay State, voluntary assignment provides each marketer with just the access that it wants to firm, primary-delivery-point capacity, permits marketers to develop efficient supply portfolios, and facilitates potentially greater savings to marketers' customers (Bay State Comments at 32).

3. Path vs. Slice

Once it has been determined whether capacity will be assigned on a mandatory or voluntary basis, the parties will decide whether these assignments will be made either on a "path" or on a "slice-of-system" basis. Although they appear similar, these bases differ in the way customers and their marketers are assigned capacity-related costs. Either of these bases could be used, whether mandatory or voluntary assignment occurs. Under a "path" approach, the LDC would assign a pro rata share of capacity along a specific contract path of the interstate pipeline system from the well head to the city gate (Joint Comments of LDCs at 50). The path approach assigns an uninterrupted route of capacity to a customer, based on linear segments of pipeline capacity that are used to serve this customer (Joint Comments of LDCs at 50, 51; Tr. 1, at 28, 29). Under a path approach, customers within an LDC's distribution system may experience different pipeline costs, because the pricing for different paths may vary (Joint Comments of LDCs, at 51; Tr. 1, at 29).[(10)]

Under a "slice-of-system" approach, the LDC would assign a pro rata share of each upstream contract in the company's portfolio to the customer (Joint Comments of LDCs at 50). Under this approach, the customer is assigned capacity at the LDC's average cost of capacity (Tr. 1, at 29).

4. Bay State Proposal

Bay State proposes that each marketer: (1) assume responsibility for 75 percent of all capacity associated with its migrating customers; and (2) bear responsibility for three quarters of all remaining unmitigated costs associated with the 25 percent of capacity not assumed, as end-users switch to unbundled service (Bay State Comments at iii). Bay State proposes that the LDCs select paths of capacity for marketers to assume; the paths selected would provide marketers with operating efficiencies and would be priced at a system or divisional[(11)] average, as appropriate (id. at 12). Bay State indicates that its proposal draws on experience with its pilot program and constitutes a balanced approach between the mandatory and voluntary alternatives to capacity allocation (id. at 33). Bay State contends that its proposed approach avoids the need to choose between "the more extreme alternatives of mandatory and voluntary approaches" (id.). The Bay State proposal would provide for annual assignment rights, with the LDC permitted to recall the capacity if a marketer failed to perform or lost its customer load (id.). Bay State maintains that, given the expected level of migration and value of unelected capacity net of all mitigation efforts, its transition costs would likely have less than a one percent effect on customer bills (id.). Bay State asserts that its proposed approach will encourage competition and minimize the potential for stranded capacity costs (id. at 12-13).

5. Positions of the Commenters

i. The LDCs

The LDCs maintain that the mandatory assignment of upstream capacity equitably allocates capacity to migrating customers and their suppliers, while continuing to maintain reliability and least-cost service to non-migrating customers (Joint Comments of LDCs at 19; Joint Final Comments of LDCs at 7-8). Under the LDCs' proposal, there would be a five year transition period to the implementation of a fully competitive capacity structure, with a Department review of the level of competition in upstream capacity at the end of three years (Joint Final Comments of LDCs at 8).

According to the LDCs, under mandatory assignment, migrating customers would retain responsibility for their pro rata share of capacity, thereby eliminating inequitable cost-shifting, the cross-subsidization of early movers to transportation service by the remaining customers, and the creation of any transition costs (Joint Comments of LDCs at 20). Moreover, the LDCs claim that a mandatory capacity assignment system would be fairer for smaller, niche marketers, which otherwise would be placed at a competitive disadvantage with national marketers that already possess capacity resources (id. at 18). The LDCs suggest that a marketer's opportunity for success would come from managing the overall costs of capacity that LDCs had already acquired and re-optimizing the LDCs' portfolio (id.).

The LDCs take issue with those marketers who contend that mandatory assignment would reduce the marketers' flexibility to achieve a resource portfolio that offers savings for customers migrating to transportation (id. at 21). According to the LDCs, once a marketer achieves an aggregate load that provides an economy of scale, there is no longer a problem with the management of small pieces of capacity (id.)

The LDCs raise four major concerns about a voluntary capacity assignment program: (1) system reliability; (2) responsibility for capacity planning and procurement; (3) implications of FERC's maximum tariffed rates for a local distribution company's ability to mitigate costs associated with unelected capacity; and (4) the development of a transition cost recovery mechanism for costs that remain stranded after mitigation is undertaken (id. at 22).

The LDCs maintain that if voluntary assignment were ordered, those marketers with existing capacity resources would have little economic incentive to elect a large portion of the capacity offered by the LDC (id. at 23). According to the LDCs, the marketers' pursuit of a "lowest cost mix of capacity" through the use of secondary delivery points, interruptible transportation, and a less-than-design-year strategy would seriously endanger system reliability in a capacity-constrained region such as Massachusetts (id.).

The LDCs argue that a voluntary capacity-release program cannot be implemented until the capacity market is workably competitive (id. at 24). The LDCs also argue that, under a voluntary program, an LDC would be unable to predict how marketers might value the LDC's capacity relative to a marketer's existing portfolio resources and that the LDCs would therefore be unable to determine how to manage capacity on a going-forward basis (id.). The LDCs argue that a voluntary capacity-assignment program would result in the premature transfer, to unregulated marketers, of the capacity planning and procurement function -- a function best left to the LDCs, at least for the near term (id.).

With respect to transition costs arising from a voluntary capacity-assignment program, the LDCs argue that assigning those costs to non-migrating customers is the kind of cross-subsidization that the Supreme Judicial Court has found to violate state law (Joint Comments of LDCs at 52-53, citing Stow v. Hudson, 426 Mass 314, 351 (1997) ("Stow") and Massachusetts Institute of Technology v. Department of Public Utilities, 425 Mass 856 (1997) ("MIT"); Joint Final Comments of LDCs at 16). Specifically, the LDCs argue that the cost-shifting issues raised by both the Marketer Group's and Bay State's proposals represent a flaw in the voluntary assignment of upstream capacity (Joint Final Comments of LDCs at 16).

ii. Marketer Group

The Marketer Group maintains that the introduction of a voluntary capacity assignment program is essential to the creation of a competitive market in the natural gas industry in Massachusetts, and meets the Department's stated objectives for the development of such a market (Marketer Group Final Comments at 9). According to the Marketer Group, voluntary capacity assignment sends clear price signals that enable consumers to make efficient energy choices (id. at 14). Mandatory capacity allocation, the Marketer Group argues, sends the inaccurate signal that all capacity is valued at the FERC maximum rate (id.).

With respect to any unelected capacity, the Marketer Group argues that migrating customers should not have to assume full responsibility for any unelected capacity (Marketer Group Comments at 5-8, 13). According to the Marketer Group, since all customers have the opportunity to benefit from competition, it is fair to allocate costs associated with the entry to a competitive market to all customers (id. at 13). Moreover, the Marketer Group argues that neither Stow nor MIT mandates a specific cost recovery mechanism, and neither requires narrow cost responsibility as argued by the LDCs and the Customer Group (Marketer Group Final Comments at 37).

The Marketer Group rejects the argument of the LDCs and others that a voluntary system would threaten system reliability (id. at 24). The Marketer Group asserts that similar arguments related to reliability were raised to and rejected by FERC in the interstate pipeline unbundling process (id. at 23-24). According to the Marketer Group, its proposal would not only maintain but enhance short- and long-term system reliability through the balance of economic incentives and continued collaborative planning (id. at 21). The Marketer Group suggests that the Department should mandate collaborative capacity planning by marketers and local distribution companies in order to ensure system reliability (id. at 27).

The Marketer Group asserts that mandatory capacity assignment thwarts the introduction of a competitive market (id. at 17). The Marketer Group argues, for example, that mandatory capacity assignment produces significant barriers to entry for smaller and low-load-factor customers seeking choice and for suppliers who are endeavoring to offer broad, mass-market offerings (id.). According to the Marketer Group, suppliers are unable to offer significant cost savings to these customers and are, therefore, hesitant to enter the market (id.). The Marketer Group asserts that Bay State's proposal presents a similar barrier for suppliers to serve all customer groups (id. at 18). In addition, the Marketer Group argues that the "slice-of-system" approach of the LDCs' mandatory proposal prevents marketers from optimizing their capacity portfolios and passing along any associated savings to customers (id. at 12,13). The Marketer Group contends that a slice approach is cumbersome to manage because it is small pieces of many contracts on many pipelines in many areas of the country (id.).

The Marketer Group suggests that there is cost-shifting inherent in a mandatory program, as a result of the elimination of lower average costs of gas through seasonal increases to remaining customers (id. at 16). The Marketer Group argues that under a mandatory capacity assignment program, consumers pay for the costs of unneeded capacity without knowing what they are paying for (id. at 14).

iii. The Customer Group

The Customer Group maintains that any capacity disposition program that the Department approves must contain mechanisms to ensure that there are no costs shifted from departing customers to those who remain on the system (Customer Group Comments at 8). The Customer Group relies on two Supreme Judicial Court decisions in its claim that the Department must only approve a capacity disposition plan that adheres to cost causation principles (Customer Group Final Comments at 9, citing MIT and Stow).

The Customer Group asserts that although the voluntary capacity assignment proposal of the Marketer Group would accelerate the introduction of a competitive market, it achieves such acceleration by shifting costs to customers who remain with the local distribution company's gas service (Customer Group Comments at 11). While the Bay State proposal limits customers' exposure to the costs of unelected capacity, the Customer Group maintains that this plan also is defective because it too would rely on shifting costs to non-migrating customers who had not caused the costs shifted to them (Customer Group Final Comments at 10 n.4).

Although not endorsing the LDCs' proposal, the Customer Group recognizes it contains mechanisms that avoid the shifting of stranded costs from departing customers to those who remain on the system (Customer Group Comments at 8). In addition, the Customer Group argues that the wholesale disposition of existing upstream capacity benefits the local wholesale capacity market, while capturing any economic rents associated with the capacity for the benefit of Massachusetts' consumers (id. at 9).

According to the Customer Group, the LDCs' proposal does not identify any stranded costs since all capacity would be assigned, and it eliminates any potential debate surrounding the prudency of those costs (id. at 11). The Customer Group asserts that a voluntary program reveals a more transparent market valuation for capacity and provides a potentially more accurate valuation of the stranded costs (id.).

With respect to the issue of transition period reliability, the Customer Group argues that there is no difference in the reliability risks associated with a voluntary or a mandatory program (Customer Group Final Comments at 6). The Customer Group submits that the Department could adopt one or more protective mechanisms, such as bonding requirements and penalties for suppliers who do not deliver, to provide the incentive against the risk of the failure to deliver (id. at 5).

Although the Customer Group states that there are positive elements in all of the proposed capacity disposition plans, the Customer Group concludes that there is no plan before the Department that meets both the minimum legal requirements for approval and the policy objectives of the Department and the Customer Group (Customer Group Comments at 12).

iv. Bay State

Bay State argues that its "hybrid" approach to capacity assignment appropriately balances the range of positions taken in the mandatory-voluntary capacity assignment debate (Bay State Comments at 13, 33). Bay State asserts that its path approach enables marketers to optimize their portfolios and derives from its experience with its pilot programs (id. at 12). Bay State maintains that the slice of system approach of the LDCs' mandatory assignment proposal results in less efficient marketer portfolios (id. at 33).

Regarding reliability of service during the transition period, Bay State argues that reliability can be ensured through its proposed insurance pool of capacity, a collaborative process of marketers and local distribution companies in capacity decisions, and coordination of capacity renewal and expansion decisions (id. at 14).

With respect to cost responsibility for any unelected capacity, Bay State argues that since all end-users will derive actual and potential benefits from competition, marketers should not bear the entire responsibility for any transition costs (id. at 18).

According to Bay State's calculations, the effect of any transition costs under its proposal would be less than one percent for all customer bills under all scenarios (id. at 33). Bay State argues that, contrary to the position taken by the LDCs and the Customer Group, it is appropriate for the Department to allocate a de minimis portion of transition costs to non-migrating customers (id. at 16-17). Bay State asserts that such an allocation is consistent with Department policy, e.g., allocating costs of demand-side management programs to all customers, including those who choose not to participate in the program (id. at 17-18).

v. Sithe

Sithe argues that the most appropriate mechanism for capacity release should be one that advances competition (for both gas and electric customers) by allowing the marketplace to operate unencumbered (Sithe Final Comments at 6). Further, Sithe maintains that developing a workably competitive capacity release market requires: (1) transparency of pricing signals; and (2) a market in which there are many buyers and sellers (Sithe Comments at 2). Moreover, Sithe argues that a voluntary capacity release plan, consistent with that proposed by the Marketer Group in this proceeding, offers the most promise to develop a competitive market both at the retail and wholesale level (Sithe Final Comments at 7). Sithe opposes mandatory capacity assignment arguing that an LDC's inefficient cost structure would be unfairly imposed on marketers to the extent that it interferes with the marketers' ability to optimize capacity assets (id.). The result, Sithe contends, is a slowing in the development of competitive markets (id.).

vi. Massachusetts Senior Action

While representatives of Massachusetts Senior Action do not support any of the proposed capacity assignment approaches before the Department, they do oppose the concept of voluntary capacity assignment. Massachusetts Senior Action asserts that the unmitigated costs of unelected capacity under a voluntary approach would be unfairly borne by customers that do not elect the services of a competitive supplier (Massachusetts Senior Action Final Comments at 2). On a going-forward basis, Massachusetts Senior Action suggests that the Department gather additional data on ways to improve wholesale capacity allocation before pursuing retail competition

(id. at 1).

vii. Tennessee Gas Pipeline

While Tennessee did not commit to supporting any of the proposed capacity assignment mechanisms, it did provide comments on how the Department might proceed with the process of unbundling. As a general matter, Tennessee recommends that LDCs continue to be involved in the gas supply planning process to ensure maintenance of system reliability in the event a third-party provider fails to perform its service obligation (Tennessee Final Comments at 6). Further, Tennessee maintains that LDCs should be permitted to hold upstream capacity contracts in their own names for the duration of the contract (id.). Tennessee argues that permitting this contractual agreement would enable LDCs to respond to emergencies, assure maintenance of system integrity, and operate to serve growth markets behind the city gate (id.).

viii. Duke Northeast Pipelines

Duke Northeast Pipelines argue that all Massachusetts LDCs should be required to honor their capacity contracts until expiration in order that LDCs may maintain service reliability (Duke Northeast Pipelines Final Comments at 1). To maintain reliability, Duke Northeast Pipelines support the LDCs' concept of mandatory capacity assignment (id. at 2). Mandatory capacity release at the full FERC rate, Duke argues, would (1) avoid the mixing of natural gas transportation and commodity cost into one product and (2) allow retention of firm capacity at primary delivery points, thus avoiding potential capacity constraints during periods of high system use (id.).

6. Discussion and Analysis

As stated in Section III, above, the Department's goal in this proceeding is to facilitate the expedient and orderly transition from regulation to competition in the gas supply market. However, the Department will promote competition only where competition is able to sustain itself. We will not attempt to create a competitive market, if the competitive market cannot develop and exist on its own or would artificially benefit only a narrow group of actors at the expense of others. In order to achieve this goal, we must ensure: (1) that all customers in the Commonwealth will continue to receive reliable service; and (2) that customers will be required to pay for only those costs that the LDC incurred in order to serve them.

The record indicates that there are three proposed mechanisms by which customers and their suppliers can obtain from the LDCs the upstream capacity needed to provide service to transportation customers. These three mechanisms are (1) mandatory assignment, (2) voluntary assignment, and (3) the Bay State hybrid.[(12)]

i. Market Conditions

Massachusetts is a winter-peaking market at the end of the interstate pipeline system. The Massachusetts market is capacity constrained. If an even more extensive move is to be made away from the current regulatory regime, then the Department must be satisfied that competitive market forces can substitute for regulatory oversight with regard to transmission services. Until the upstream capacity market is workably competitive, the Department concludes that mandatory assignment will ensure that existing levels of reliability will be maintained at a reasonable cost. Without a reliability standard for marketers, a standard that could be implemented, monitored, and effectively enforced, the Department is of the opinion that reliability could be jeopardized under the voluntary capacity assignment proposal. Moreover, until more is known about the direction of the gas market nationally, the Department is reluctant to impose this potential reliability risk on the Commonwealth's economy at large, or on its gas ratepayers in particular.

For the reasons provided below, we find that the upstream capacity market is not yet workably competitive. Currently, there are only two primary pipelines flowing into Massachusetts. This upstream capacity, which is leased almost exclusively by the LDCs, is sufficient to meet the peak winter needs of the Massachusetts market only with the addition of peaking and storage services supplementing the pipeline capacity. We expect that current FERC initiatives along with the introduction of more capacity options, combined with the unbundling of the LDCs, will bring the upstream capacity market closer to full competition. For the Department to regard this capacity market as fully competitive, the FERC-imposed price controls on interstate pipeline capacity must be lifted. In addition, the number of alternative contract holders with firm rights to the interstate pipeline capacity must increase. These preconditions remain to be fulfilled.

Therefore, the Department determines that the level of competition in the upstream capacity market is insufficient to allow us to remove traditional regulatory controls. To ensure the continued deliverability and reliability of gas at reasonable prices, the LDCs must continue with their obligation to plan for and procure sufficient upstream capacity. The five-year transition period proposed by the LDCs is appropriate. Further, we agree that the Department should reevaluate the status of competition in the upstream market at the end of the first three years of the transition period.(13) Moreover, until a fully competitive capacity market has developed, the Department believes that the capacity assigned to customers and their marketers must be subject to certain restrictions, such as recall rights.(14) The right of an LDC to recall capacity will ensure that adequate capacity will be available to the LDC and that deliverability to the LDC's city gate and the LDC's customers will be maintained in the event customers switch suppliers or return to the LDC's default service.(15)

ii. Voluntary Assignment

Given the proper market conditions, voluntary assignment would be the most expeditious way to achieve the Department's long-range objective of a fully competitive gas industry in which all customers would have the option to purchase gas commodity and transportation capacity from a wide range of providers operating in a competitive market. Voluntary assignment may also encourage greater participation by marketers initially, because marketers would be able to take less capacity than the LDCs currently hold. As a result, they would be able to enter the market with operating costs lower than the LDCs'.

However, as explained below, based on the evidence provided to the Department, without a workably competitive upstream capacity market, it appears that voluntary assignment is - for the present -- inconsistent with the Department's goals that (1) all customers in the Commonwealth continue to receive reliable service and (2) customers pay for only those costs that the LDC incurred in order to serve them. Under a voluntary assignment scenario, customers may elect assignment of capacity that is less than the volume that has been considered, historically and as a matter of contract, necessary to serve them. As a result, these customers may receive unreliable service and costs may be shifted from them to non-migrating customers. At the time of the three year evaluation or at the close of the five year transition period, market conditions may be ripe for a full move to voluntary assignment. That judgment can, however, be made only in light of future events.

The Department agrees with the LDCs that under the voluntary assignment regime, marketers would have an incentive to choose less than a full assignment of their pro rata share of capacity and the associated costs in order to increase savings to migrating customers. These savings would be generated by shifting some of the capacity costs to non-migrating customers, by deferring the collection of such costs to a later date, or by imposing them upon the LDCs that undertook the contractual obligation in order to meet their obligation to serve. Put simply, the transition costs that result from a voluntary capacity assignment represent avoidance of existing LDC cost commitments in order to create some of the cost savings for migrating customers and opportunities for marketers. Marketers have stated that unless they can avoid or defer the capacity costs currently owed by the LDCs, they may not be able to compete and, therefore, would not be able to offer retail service in Massachusetts.

Marketers have argued that they must offer a discount from the LDCs' prices in order to attract customers. They maintain, therefore, that the Department should ensure that they have an adequate margin between their costs and the LDCs' rates to enable them to offer such a discount. This argument suggests a misconception of the Department's role in promoting competition. Our role is not to guarantee the success of entrants. Rather, our role is to put in place the structural conditions necessary for an efficient competitive process -- one where marketplace decisions of both producers and consumers are made on the basis of incremental costs. An efficient, unbundled gas industry framework would allow customers to compare the LDCs' incremental costs to marketers' incremental costs. However, this comparison cannot be made if historic cost commitments are imposed asymmetrically on the LDCs. In other words, if LDCs must include the inefficient costs of past commitments in their prices,(16) while marketers are not required to include those costs for customers who choose to migrate, then marketplace decisions, at least in the near term, are being made on the basis of an asymmetric allocation of historic cost responsibility, not on the basis of incremental costs. This does not lead to efficient competition.

The LDCs have a present obligation to provide reliable, least-cost service for existing customers. Under a voluntary assignment scenario, if there is unelected capacity that migrating customers have left behind, the LDCs would be required to mitigate those costs, to the extent possible. An LDC, therefore, would have a compelling incentive to release the unelected capacity either permanently or on a multi-month basis without recall rights.(17) If the LDC were to release capacity without recall rights, the capacity could be diverted from the LDC's traditional customers to other customers, thereby (1) limiting the volume of gas that can flow into Massachusetts and (2) impairing prospects for growth of the natural gas market in Massachusetts.

iii. Cost Effects

Under a voluntary system of capacity assignment, customers migrating to transportation service could leave behind costs that the LDCs have incurred on their behalf. If all of these net, non-mitigable costs are not assigned to the migrating customers, the LDCs would have to recover them from the remaining, non-migrating customers who, as a result, would experience price increases unrelated to their cost of service. Such a result is in direct conflict with the Department's well-established policy on cost allocation, viz., that cost responsibility must follow cost incurrence. See Boston Gas Company D.P.U. 96-50 (Phase I), at 133-134 (1996); Boston Gas Company D.P.U. 93-60, at 331-337, 410, 432 (1993); Bay State Gas Company, D.P.U. 92-111, at 54, 283-284, 311-312 (1992); Boston Edison Company, D.P.U. 1720, at 114 (1984); Generic Investigation of Rate Structures, D.P.U. 18810, at 14 (1977).

We acknowledge that marketers may previously have acquired capacity resources and that assigning to them the cost of the LDCs' existing contractual commitments may affect their ability to compete during the transition period. However, this effect on marketers can and should not constrain the Department from equitably assigning the known costs of moving from the regulated environment to an unregulated, competitive market.

By way of example, when FERC restructured the pipelines several years ago pursuant to Order 636, the LDCs were automatically assigned pieces of the pipelines' capacity from the wellhead to the city gate. The LDCs were required to accept the assigned capacity on a multitude of pipelines, including being assigned small slivers of upstream capacity on certain pipelines that the LDCs might not consider convenient. FERC dealt with the LDCs as regulated entities that could be required to take the assigned costs; FERC did not let the LDCs choose the amount or type of capacity that might best fit an individual LDC's needs. The LDCs were not allowed to refuse the capacity or associated costs; they were required to take the capacity contracts they received. Thereafter, they could choose to release or re-optimize these contracts.(18)

Likewise, as the Department moves toward customer choice and a competitive environment for gas suppliers, we must acknowledge and account for existing circumstances. This Department has previously required each LDC to make adequate plans for both gas supply and gas capacity. Each LDC has had an absolute requirement to ensure that every one of its existing customers received gas on any given day. This regulatory requirement has compelled the LDCs to enter into long-term supply and capacity contracts. Supply contracts have been reviewed under G.L. c. 164, § 94A. Thus, the Department cannot dismiss or overlook the argument that these contracts have been prudently entered into and that the LDCs are entitled to recover the mitigated, stranded costs of prudent contracts in the event of voluntary assignment.

The Department does not believe that facilitating customer choice of gas suppliers requires us to allow competitors to enter the marketplace without paying a proportional share of the existing contract costs. Nor do we believe that a deferral mechanism for recovery of these costs is today sound policy for the local gas industry. The contractual obligations of the LDCs to the pipelines exist and, as noted, must be acknowledged. Accumulating the transition costs into a pool for later collection, as proposed by the Marketer Group, may artificially make current prices for marketers appear lower, and the price for LDC service appear higher. However, unless the LDCs were able to mitigate all of the costs, the residual costs would remain to be collected from customers at a later date. Thus, we believe such a deferral would contrive a short-term discount to marketers in an effort to jump-start competition. The result would not lead to efficient competition capable of self-sustainment over the long term.

In contrast, we find that the mandatory "slice-of-system"[19] approach will allocate capacity costs to all customers on an equitable basis. All customers under a mandatory assignment approach will pay for the pro rata share of existing pipeline capacity that is necessary to meet their needs. Marketers can be assigned a pro rata share of capacity along with the pro rata share of associated costs and still manage to compete effectively against other marketers, as well as the traditional LDC. This structure constitutes a fair market regime for all. This competition would be sustainable because it would be based on the underlying capabilities of the marketers, not on perhaps short-lived circumstances existing during the transition period. The fact that marketers may own capacity rights to serve their current customers, in Massachusetts or other New England states, cannot be used to relieve these marketers from assuming their share of existing capacity commitments.

We note that the LDCs and the marketers will have to work together cooperatively concerning the status of existing and future contracts and their renewal and termination. If the five-year transition period is to position Massachusetts for future competition, then the LDCs should take all reasonable and necessary steps to review and manage existing commitments so as to avoid the incurrence of any unnecessary contract costs. Mandatory assignment in no way diminishes an LDC's responsibility to manage its capacity assets actively in a way that maximizes efficiency and minimizes the potential for future stranded costs. The Department views mandatory assignment as a transitional device to bridge the period between existing LDC responsibility for contract costs and the competitive environment of the future. Throughout the transition period, we anticipate -- events at the FERC permitting -- that a competitive market will develop. Once a competitive market has developed, marketers may be in a position to contract directly for pipeline capacity in their own names, and the LDCs will have only a responsibility to deliver the gas arriving at its city gate.[20]

Accordingly, for all these reasons, the Department concludes that the mandatory slice-of-system approach to capacity assignment is the regulatory framework appropriate to a transitional market. Mandatory-slice capacity assignment enables converting customers to gain access to capacity, while maintaining reliability and avoiding improper transfer of cost responsibility.

B. Downstream Capacity

Downstream capacity and assets are commercial gas operations owned and managed by an LDC as part of its distribution system and, therefore, closer to the retail market. In Massachusetts, downstream assets refer to LNG and propane storage facilities. The LDCs have traditionally needed these facilities to deliver peaking supplies and in some instances to maintain system pressure.

1. Proposal/Positions of the Commenters

The LDCs described two approaches for making downstream assets available to migrating customers (Joint Comments of LDCs at 61). The first approach would make these assets available through a mandatory peaking service (id. at 62). Under the mandatory peaking service, the charge to the customer would have two components: one related to capacity and one related to commodity (id.). The capacity component, which would be a demand charge, would reflect the customer's pro rata share of downstream peak-demand capacity costs (id.). If the customer uses the commodity peaking resources of the local distribution company, the customer would be charged for the actual commodity purchased from the peaking facilities (id.). The amount of gas that the customer could use under this approach would be limited to the pro rata level of capacity that is allocated to the customer (id. at 63).

The second approach, mandatory "virtual" capacity release, would also make the downstream assets available on a pro rata basis (id. at 62). Customers would pay for their pro rata share and would be entitled to use the capacity (id.). The method is referred to as "virtual" because the operational parameters for maximum and minimum inventory levels during the year would be established by the LDC or the operator of the facility; customers or their marketers would not have flexibility in using this capacity (id. at 62). The LDCs note that operational or logistical constraints may limit the extent to which marketers are permitted to place their own gas into the inventory of the LDC's facilities (id.).

The Marketer Group states that downstream assets are not necessarily natural monopolies and should be unbundled to the extent possible (Tr. 3, at 100). The Marketer Group proposes that during the transition period, downstream assets should be provided on a cost basis, or what has been referred to as "virtual" assignment (id. at 100). The Marketer Group does not support the mandatory assignment of downstream assets (id. at 116).

The Customer Group does not have a position on downstream assets (id. at 104). The Customer Group notes that these assets would be more important in an unbundled market because there are few ready substitutes for them (id. at 106). The Customer Group suggests that downstream assets should be treated the same way upstream assets are, with the exception of operational control (id. at 104). However, the Customer Group argues that using a pro rata method for the mandatory assignment of downstream assets would be problematic (id. at 115-16). In particular, the Marketer Group asserts that using an allocation method based on peak-day usage would assign high-load-factor customers some downstream assets (id. at 116). The Customer Group argues that a high-load-factor customer should have the option of being assigned only pipeline capacity (id.).

2. Discussion and Analysis

As earlier noted, downstream assets serve two purposes (1) to provide peak shaving supplies and (2) to maintain system pressures. Downstream assets are an integral part of the distribution market. Therefore, to the extent that operations permit, we will require LDCs to unbundle their downstream assets and make the components available to competitors.

Although the Marketer Group does not support the mandatory assignment of downstream assets, it supports the LDCs' proposal of a "virtual" assignment. We believe that the "virtual" assignment of downstream assets will assist in the development of a competitive gas market. "Virtual" assignment will allow marketers to participate more fully in the market and use the downstream supplies in a manner akin to a competitive market. As with the assignment of upstream capacity, if downstream assets were assigned on a voluntary basis, the same issues regarding cost responsibility and cost shifting would arise. In particular, the Department notes that under a voluntary assignment of downstream assets, customers who have elected to remain with the LDC will not only be required to pay for the costs associated with the LDC's provision of service to them, but also for a portion of costs remaining after reasonable mitigation efforts resulting from migrating customers' refusal to assume assignment of downstream capacity. The Department maintains that such cost shifting is inappropriate, and, therefore, we will not authorize it. The Department finds that the mandatory "virtual" approach to assigning downstream assets and capacity, as proposed by the LDCs, is reasonable for the transition period.

The Department envisions that access to the downstream assets currently held by the LDCs would eventually become available to marketers on a fully competitive basis. In the future, as more customers migrate to transportation, as the number of marketers increases, and as a workably competitive downstream market develops, customers and their suppliers would be able to determine more accurately whether and to what extent they need access to these downstream assets. At that point, marketers would be in a better position to estimate how much of the downstream storage or peaking capacity is necessary to ensure reliable delivery of the gas commodity to their customers. In turn, the information regarding demand and future usage would enable an LDC to determine whether it remains economically efficient for an LDC to maintain the existing assets or to develop alternative facilities that would better match the operational and economic needs of the market. Downstream storage assets would be developed and managed in a manner similar to the current management of the upstream underground storage facilities, now being used by the Massachusetts LDCs.

V. <u>CONTRACT RENEWAL AND SUPPLY PLANNING RESPONSIBILITY</u>

A. <u>Introduction</u>

Because many LDC upstream capacity contracts will expire during the next few years, the Department has questioned the commenters as to the appropriate process and responsibility for determining whether these contracts should be renewed or permitted to expire.

B. <u>Positions of the Commenters</u>

Views of the commenters on contract renewal and supply planning responsibility generally followed their positions concerning access to upstream capacity resources. The Marketer Group suggests that: (1) the LDCs share capacity planning risks and responsibilities with the marketers; and (2) that the necessary planning and communications protocols be developed through collaborative efforts (Marketer Group Final Comments at 34). The Marketer Group notes that the LDCs should not release capacity on a permanent basis during the transition period (id.). The Marketer Group further contends that the LDCs' obligation to serve customers should be subject to competitive bidding after the transition to competition has been completed (Marketer Group Comments at 18-19). The Marketer Group agrees that the LDCs should stay in the planning and contracting business during the transition period (Marketer Group Final Comments at 34).

The LDCs have indicated that, absent a workably competitive capacity market, the LDCs must retain sole control of capacity renewal for as long as they are responsible for system supply and reliability (Joint Final Comments of LDCs at 32-33). The LDCs state that, until the Department can conclude that a reasonably competitive capacity market exists to provide adequate capacity, the LDCs must retain control over the contracting role (id.). The LDCs propose that they retain responsibility for planning and procurement for at least three years or until the Department determines that the upstream capacity market is workably competitive (Joint Comments of LDCs at 8).

Bay State proposes that the LDCs retain renewal rights for capacity released to suppliers and acquire new capacity, if needed, to meet load growth (Bay State Comments at 13-14). Renewal decisions would be made in consultation with retail marketers, followed by the LDC filing a request for renewal/cancellation with the Department (id.). Contracts to be canceled would be offered to marketers on the LDC's system (id. at 14). An insurance pool would be used to provide temporary service in the event that a supplier fails to perform (id. at 13-14, 29).

The Customer Group recognizes that "the issue of expiring pipeline contracts is complex" and advocates renewal of the expiring Tennessee contracts for a five year period (Customer Group Final Comments at 5).

C. Discussion and Analysis

To ensure the provision of reliable gas service, the Department concludes that, at least during the first three years of the transition period, the LDCs must continue with their obligation to plan for and procure necessary upstream capacity to serve all firm customers. LDCs would recontract for capacity on an as-needed basis, subject to the approval of the Department.[(21)] Although the management of capacity resources may be turned over by some LDCs to the wholesale market through the portfolio auction discussed in section VI. below, decisions regarding the renewal of expiring contracts must be made by the LDCs, in accordance with their obligation to serve. These renewal decisions should be preceded by discussions with marketers in order to assure that the LDCs' decisions will take into account customer migration to transportation service, system growth and the trend of marketer participation in the LDCs' markets. Similarly, LDCs may enter into new contracts as necessary to meet existing firm requirements and incremental load growth consistent with established Department planning standards. In this way, the LDCs would have the ability to serve customers returning to the distribution system for default service or to act as the supplier of last resort in the event that suppliers or marketers fail to perform.

As we indicate above, at the end of the first three years in the transition period, the Department will evaluate the level of competition in the upstream capacity market and determine whether the market is sufficiently competitive to warrant the removal or modification of the LDCs' service obligation with respect to acquiring capacity.[(22)] At that time, the Department will consider a number of factors including, but not limited to, the number of transportation customers, the number of marketers, the percentage of the market that has converted to transportation service, and developments at FERC. Until the Department determines that the market is sufficiently competitive, the LDCs would continue with their obligation to plan for and procure capacity resources.

Although the LDCs will retain their primary responsibility for assuring system reliability during the transition period, we recognize that a smooth transition to an unbundled, competitive market for natural gas requires considerably more cooperation among the collaborative participants than may have occurred in pre-MGUC years. The Department, therefore, requests that the Collaborative propose a mechanism by which the LDCs can include other members of the Collaborative or other affected market participants in an LDC's capacity planning process.

VI. PORTFOLIO AUCTION

A. Description of Proposal

The LDCs have proposed a Portfolio Auction to transfer, for a term, the management of LDC gas and related capacity resources to unregulated marketers as a step to encourage the development of competitive commodity markets (Joint Comments of LDCs at 30). The Portfolio Auction, as proposed by the LDCs, assumes implementation with mandatory capacity assignment subject to full recall rights to achieve its objectives (id. at 37). The LDCs acknowledge that voluntary capacity assignment could also be used with the Portfolio Auction; however, they contend that the portfolio value would likely be reduced (Tr. 4, at 173).

The LDC's Portfolio Auction would transfer, via competitive bidding, the management of the LDC's upstream pipeline capacity, storage, and gas supply commodity contracts to competitive wholesale marketers for a fixed time period of three to five years (MGUC Report, Att. D at 2-3). The LDCs propose that the winning bidder of the Portfolio Auction also be required to: (1) provide city-gate supply service to the LDC so that the LDC can fulfill its obligation to provide default service to those customers opting not to select an alternative retail gas supplier[(23)]; (2) make all payments and day-to-day decisions associated with the managed upstream resource portfolio; and (3) retain firm capacity at primary delivery points to ensure peak-day deliverability and preserve system integrity (id. at 4-5).

In an effort to maximize the potential bid value of the assets for Portfolio Auction disposition (by minimizing the potential risk for bidding portfolio managers), the LDCs propose that the following criteria be included in a Request for Proposals ("RFP"): (1) the contract term of the managed asset; (2) the pricing structure for default service; and (3) the type of capacity assignment mechanism employed to transfer pro rata capacity rights to migrating customers (id. at 7). Each of these components is summarized below.

1. The Contract Term of the Managed Asset

The LDCs propose that the contract term be a minimum period of three to five years, corresponding to the length of the transition period to a fully competitive market (id.). The LDCs claim that this time period will insulate portfolio managers from the volatility of a short-term movement in commodity price (id.). Further, the LDCs propose that the term should be determined in conjunction with the pricing mechanism (i.e., fixed, floating, or indexed), the capacity assignment program (mandatory or voluntary), and any restrictions imposed on the rate of customer migration (id.).

2. The Pricing Structure for Default Service

The LDCs maintain that floating or indexed pricing would enable the price for default service to track market conditions but reduce the risk to the portfolio manager(id. at 8). They conclude that this approach would allow customers who take default service from LDCs to experience price fluctuations based on the commodity price for gas (id. at 8-9). Conversely, a fixed price could effectively insulate customers from commodity fluctuations but could also deny customers the benefit of price decreases (id.). The LDCs propose that the issue of pricing be resolved in the context of an LDC-specific RFP process to ensure that the dynamics of each individual LDC can be addressed (id. at 9).

3. Mechanism for Capacity Assignment

The LDCs state that the Portfolio Auction, when used in conjunction with a mandatory capacity assignment process, will not only maximize the bid value of the Portfolio Auction, but will also (1) maintain system reliability through the transition period, (2) eliminate cost shifting, and (3) be even-handed to all retail competitors (id. at 9). In support of these contentions, the LDCs note that a marketer's perception of bid value in a portfolio auction will depend, in large part, upon the risks associated with the transaction (id.). The LDCs contend that absent a mandatory capacity assignment mechanism, gas industry restructuring has the potential to result in unnecessary price increases for customers (id. at 10). Moreover, the LDCs argue, the voluntary capacity assignment proposal would reduce the value of a given portfolio because migrating customers would expose potential wholesale marketers to unquantifiable risks by electing to forego their pro rata share of capacity and thereby creating stranded capacity costs (id. at 9-10). In the absence of a capacity assignment mechanism that significantly reduces or eliminates the risk associated with the cost of unelected capacity, the value of the portfolio will be correspondingly reduced (id. at 9).

As a final element to enhance bid value in the Portfolio Auction, the LDCs originally proposed controlled levels of annual customer migration to alternative suppliers (id. at 8). Doing so would increase the predictability of wholesale providers' management of resources and thereby tend to increase bid value (id.). The LDCs recognized, however, that such restrictions may run counter to a concept of full and immediate market competition (id. at 8). The LDCs consequently retracted this component from the proposed RFP process (Tr. 4, at 148-49). In its place, the LDCs propose a mechanism whereby a Portfolio Auction RFP would solicit wholesale marketer reaction to hypothetical migration limitations (id. at 149). The LDCs argue that this type of scenario-testing would provide information to assess the effect of migration-limitation on capacity value, without actually imposing any such limitations (id. at 149-150).

B. Positions of the Commenters

1. Bay State Gas Company

Bay State contends that, if the Department determines that a Portfolio Auction is consistent with customer choice, the auctioning of an LDC's assets should be discretionary with each LDC (Bay State Comments at 42). Bay State argues that successful unbundling of an LDC's services does not require that an LDC's capacity portfolio be outsourced through an auction process, nor does portfolio outsourcing necessarily contribute to benefits achieved through unbundling (id. at 38). In further support of discretionary outsourcing, Bay State contends that the asset management contract, which is highly dependent upon the terms and conditions of the auction, will allocate risks as well as economic benefits between the asset manager and the LDC (Bay State Final Comments at 41). Bay State argues that the LDC should therefore have the option to evaluate these risks as an integral component of its overall assessment of the contract (id. at 41).

Bay State identified numerous limitations of the LDCs' Portfolio Auction proposal with respect to opening markets to full competition (id. at 41-44). First, Bay State believes that the proposed Portfolio Auction process will create potential market power[(24)] issues that will need to be addressed (id. at 42). To this end, Bay State proposes that the Department impose specific affiliate standards to ensure that capacity is offered to retail marketers on fair terms (id. at 43). Second, Bay State believes that significant changes will occur in both the wholesale and retail markets over the next two years (id. at 44). Therefore, to minimize an LDC's risk brought about by these indeterminate changes, Bay State proposes that the term of the Portfolio Auction not exceed two years (id. at 45).

Third, Bay State argues that the LDCs' proposal to restrict migration rates and levels, if instituted, would have an adverse effect on (1) customers by curtailing their options to select a competitive supplier at their leisure and (2) marketers whose business would be constrained by managed migration rates and levels (Bay State Comments at 40).

Fourth, Bay State takes issue with the LDCs' option that the asset manager provide supply services to customers at a fixed price (id.). Bay State argues that the potential for customer dissatisfaction is significant if market prices decline below the fixed price and customers are precluded from switching to an alternative supplier because of imposed migration limitations (id.).

Fifth, Bay State contends that the Portfolio Auction may impede the development of a fully competitive market with the inclusion of wholesale marketers in the capacity assignment process (id.). Bay State argues that retail marketers may not know the ability of the wholesale marketers to develop and exercise market power and may, therefore, choose to conduct business in other emerging markets where risks are perceived as lower (id.). Bay State is concerned the Department may lack the jurisdiction to address market power issues relative to marketers (id.).

Sixth, Bay State is concerned that the LDCs' incremental benefits of contracting with an asset manager have not been fully evaluated relative to the incremental management-related fees of asset managers (id.). Finally, Bay State contends that the market for asset management is highly competitive and quickly changing (id. at 41). Bay State is concerned that an LDC entering into a multi-year agreement with a wholesale marketer may forego benefits that may otherwise be available at a later date (id.).

2. The Marketer Group

The Marketer Group also has numerous issues with the Portfolio Auction process as proposed by the LDCs. First, the Marketer Group argues that the Portfolio Auction, as proposed, raises market power issues because the LDC, as a regulated monopoly of upstream capacity portfolio assets, would simply be replaced with an unregulated monopoly (Tr. 4, at 115). The Marketer Group recommends that the Department develop a strong, enforceable code of conduct to prevent potential abuses of market power during the term of the Portfolio Auction (Marketer Group Final Comments at 53). The Marketer Group proposes that the code of conduct govern: (1) wholesale and retail affiliates; (2) the wholesaler and the LDC whose assets the wholesaler is managing; and (3) the wholesaler and any of the LDC's affiliates (Marketer Group Comments at 10; Marketer Group Final Comments at 54).

Second, the Marketer Group argues that a two to three year term would be a more reasonable time span (as opposed to three to five as proposed by the LDCs) considering the dynamics in the New England natural gas market (Tr. 4, at 115-116).

Third, the Marketer Group argues that a Portfolio Auction in combination with mandatory capacity release may offer short-term initial savings to customers, but will result in less savings in the long run, because it will likely delay the development of a competitive retail market (Marketer Group Comments at 7; Marketer Group Final Comments at 52).

Fourth, the Marketer Group opposes placing any limits on migration levels under the Portfolio Auction process (Tr. 4, at 116). The Marketer Group contends that migration limits would impede the growth of competitive markets by (1) creating a disincentive for establishment of marketer presence; and (2) preventing customers from selecting a competitive supplier at their will (id.).

Fifth, the Marketer Group argues that the issue of implementing a Portfolio Auction should be addressed in the context of an appropriate default service mechanism (Marketer Group Final Comments at 51). Until the Department offers guidance with respect to capacity assignment, the Marketer Group contends that it is premature to determine the nature of default service (id.). The Marketer Group takes the position that current circumstances do not support implementation of a Portfolio Auction (id.).

Finally, the Marketer Group argues that the Portfolio Auction proposal could work under a voluntary program in such a way that, as customers migrate, their pro rata share of capacity would move out of the portfolio management pool and into a mitigation pool[(25)] (Marketer Group Final Comments at 52-53). In this manner, the Marketers contend that a portfolio manager would be insulated from carrying a disproportionate share of above-market capacity (id. at 53). The Marketer Group proposes that unelected, above-market-rate capacity would be mitigated by either the LDC or another wholesale marketer participant (id.).

3. Customer Group

The Customer Group argues that neither the LDCs' mandatory capacity Portfolio Auction nor the Marketer's voluntary capacity Portfolio Auction proposal satisfy the Department's policy objective of developing a competitive commodity market (Customer Group Comments at 11-12). The Customer Group, however, believes that a modified Portfolio Auction proposal, developed from the integration of the positive elements of each proposal, may yield a plan that meets the Department's legal and policy requirements (id. at 12). To this end, the Customer Group has outlined the perceived strengths and weaknesses of the Portfolio Auction proposal (id.).

The Customer Group concurs with the LDCs on the importance of seeing that migration does not lead to creating stranded costs and then shifting these costs to non-migrating customers if a Portfolio Auction is undertaken (id. at 8). The Customer Group believes that the LDCs' inclusion of a competitively priced service for non-migrating customers, coupled with the pro rata share of capacity following migrating customers, accomplishes these objectives (id.). The Customer Group further concurs that the bundled disposition of an LDC's existing upstream capacity assets (i.e., interstate pipeline and storage contracts) via a wholesale marketer will enhance the value of their mitigation efforts to the benefit of consumers (id. at 8-9). Finally, the Customer Group believes that the Portfolio Auction process will stimulate the development of the wholesale market (id. at 9). The Customer Group disagrees with the LDCs' Portfolio Auction proposal, however, arguing that it (1) fails to include downstream assets in the portfolio auction, (2) fails to identify stranded costs, and (3) creates potential barriers to entry in the retail market[(26)] (id. at 9-10).

The Customer Group argues that the Marketer Group's suggested voluntary capacity assignment approach to the Portfolio Auction would reduce the potential barrier to entry by allowing marketers to select only those contracts it desires from a migrating customer's pro rata share of capacity (id. at 10). Further, the Customer Group contends that a voluntary capacity release component to a Portfolio Auction would provide (1) a more transparent market valuation for the LDC's capacity; and (2) a better valuation of stranded costs (id. at 10-11). The Customer Group's argument against the Marketers' portfolio auction approach, however, is that the evolution to a competitive market would be accomplished by unfairly shifting costs to customers who choose not to elect a competitive supplier (id. at 11). The Customer Group argues that restructuring must be accomplished in a manner that provides benefits for all customers and protects against shifting costs onto those customers who remain "on the system" (id., citing MIT at 872 and Stow at 351).

4. Sithe

Sithe argues that, conditional to any Portfolio Auction proposal, enforceable mechanisms must be in place to prevent undue concentration of both vertical and horizontal market power among individual marketers and their affiliates (Sithe Final Comments at 3). Sithe further contends that a Portfolio Auction process is not necessarily a requirement for obtaining maximum contract value (id. at 5). Sithe proposes that allowing LDCs to establish their own schedule and processes for outsourcing capacity management, subject to Department approval, is a practical alternative to a mandated auction process (id.).

5. El Paso

El Paso believes that the institution of a Portfolio Auction mechanism would maximize the LDC's upstream capacity resources to the benefit of both migrating and non-migrating customers (El Paso Initial Comments at 1, 7). In bridging the gap between the LDCs' and the Marketer's perception of capacity election under a Portfolio Auction mechanism, El Paso recommends a hybrid approach (id. at 1). El Paso suggests that wholesale marketers be allowed the opportunity to bid for the right to manage an LDC's upstream capacity assets for a transition period of five years (id. at 1-2). Upon bid award, the LDC would assign the capacity required to meet its default service to the wholesale marketer on a recallable basis for the five year term of the transition period (id. at 2). El Paso explains that, as customers migrate off the system during the transition period, the retail marketers would be given a one-time opportunity to take up to a pro rata share of the LDC's capacity resources at the applicable FERC tariff rate (id. at 1-2). This elected capacity would be assigned to the retail marketers on a permanent basis (id. at 2). The difference between the volume migrating to the retail marketers and the corresponding capacity elected by the retail marketers would be permanently[(27)] assigned to the awarded wholesale marketer at the applicable FERC tariff rate (id. at 2).

El Paso asserts that its proposal offers benefits to (1) migrating customers in the form of lower gas costs created through competition; and (2) non-migrating customers through the asset management expertise of the wholesale marketer (id. at 7). El Paso further asserts that success of its hybrid Portfolio Auction proposal is contingent upon (1) a fully competitive upstream capacity market, (2) the permanent release of LDC upstream capacity resources to retail and wholesale marketers, and (3) the functional separation of wholesale and retail marketers to minimize the potential for market power (id. at 6-7).

6. LDCs

The LDCs argue that the Portfolio Auction proposal will meet the Department's principles for a competitive gas market by (1) transferring to the wholesale market[(28)] the management and utilization of capacity resources currently under contract to LDCs,

(2) functionally separating the LDC's supply operations from distribution, (3) providing migrating customers and their competitive suppliers with access to capacity held by the LDCs during the transition period, and (4) providing all customers with lower prices[(29)] as a result of efficiency gains achieved through competitive market capacity transactions without shifting responsibility for current cost commitments (Joint Final Comments of the LDCs at 19-20). The LDCs also anticipate the following benefits to result from implementation of the Portfolio Auction: (1) LDCs will be removed as competitors from the merchant segment of the industry; (2) issues of self-dealing will be resolved because the distribution system operator and the administrator of the capacity release program will each lack the incentive to use its position to disadvantage competitive suppliers; and (3) the Portfolio Auction will encourage the development of competitive gas markets by enabling wholesale marketers to manage the LDC's capacity (Joint Final Comments of the LDCs at 20; Tr. 4, at 104).

C. Discussion and Analysis

The Portfolio Auction process, proposed by the LDCs in conjunction with mandatory assignment of capacity, is a mechanism suited to provide all Massachusetts gas customers with reliable, safe, and least-cost service. The Portfolio Auction has the potential to provide all customers with efficient administration and use of the LDC's upstream assets, and for that reason we approve the concept. However, the Department is not convinced that the auction will provide equal benefits for each and every LDC. Because we remain unconvinced of its universal applicability, we do not mandate the Portfolio Auction. Instead, although we encourage resort to individual portfolio auctions, each LDC should determine whether a portfolio auction is likely to provide economic and other benefits for its customers. Each LDC should make its own decision whether to outsource the management of its portfolio. Certain LDCs may value the prospect of employing the services of an upstream capacity manager. Other LDCs may determine that their particular upstream assets will not benefit from recourse to a portfolio auction. Of course, each LDC's decision concerning use of an auction will be subject to continuing Department review, as is currently the case, in the context of long-range forecast and supply plans to insure that the LDC is making decisions in the best interests of its customers. Where an LDC forgoes a portfolio auction, the LDC should be prepared to justify to the Department why it has foregone this approved concept. The Portfolio Auction, if used, should be fair, open, and transparent. Each auctioning LDC should keep adequate records which could be used to document results and savings.

Numerous issues were raised concerning various details of the Portfolio Auction. These issues include the term length of the contract, the various pricing mechanisms, possible limits on the level of migration, inclusion or exclusion of downstream assets, and market power concerns. These issues, which are addressed in more detail below, were raised in addition to the major issue of whether assignment of capacity should be on a mandatory or voluntary basis. We have resolved the assignment issue in favor of mandatory assignment, at least for the transition period. The Department's capacity decision does potentially affect the Portfolio Auction when it comes to the term of the contract. An LDC should not commit to an auction period assuming mandatory assignment, if the term of the auction would extend beyond the transition period.

The Department disapproves placing limits on the level of customer migration under the Portfolio Auction. Customer, not provider, benefit is the focus of this entire effort to promote competition. The Department is attempting to provide additional choices to all customers. Placing limits on migration levels in a Portfolio Auction process would run counter to customer choice and would restrict the ability of alternative suppliers to offer their services at reduced prices to the marketplace. Fostering a competitive environment would be hampered, not enhanced, if limits were placed on migration levels.

In addition, fixed prices are not in the customers' best interests. While customers would be protected from increased prices, they would also be foreclosed from receiving any benefits from reduced prices. At this juncture, an indexed or floating pricing mechanism is preferable. Proposals from LDCs that disregard this preference will require justification.

The effect of wholesale marketers' presence in the development of a fully competitive retail market is still uncertain. In the absence of any proposed mechanism to alleviate the potential for abuse of market power, wholesale marketers, as auction winners, could discourage the full development of retail competition. Therefore, the Department agrees with the Marketer Group that safeguards may well be needed to prevent market power abuses. Each of the participants in this proceeding appeared to acknowledge that the issue of market power would need to be addressed in the context of the Portfolio Auction. Therefore, the Department suggests that the Collaborative develop standards concerning wholesale and retail marketers' participation in the market area in connection with the Portfolio Auction and present such standards to the Department for review. In addition, an LDC that elects a portfolio auction should hedge against potential for abuse by evaluating the portfolio manager's conduct during the term of the LDC's portfolio management contract to discover and correct any propensity for market power abuse by the successful bidder.

Auctioning or outsourcing of an LDC's upstream capacity assets will be at the discretion of each LDC. If an LDC decides to pursue a Portfolio Auction, all contractual components (i.e., term, default service, administrative fees, etc.) need to be negotiated between the LDC and the bidder chosen as upstream capacity manager. An LDC must provide the terms of any proposed Portfolio Auction to the Department in advance. The Department will require each LDC to (1) provide the Department with the RFP and (2) file with the Department a description of its outsourced upstream capacity management program. After an auction award, the LDCs shall file with the Department annual progress reports describing the financial and service effect on the company's customers. The Department will review, for approval, the outsourcing of the management of LDC upstream capacity prior to implementation.

VII. SUMMARY

The Department's goal in this proceeding is to facilitate the expedient and orderly transition from regulation to competition in the gas supply market. In order to achieve this goal, we must ensure (1) that all customers in the Commonwealth will continue to receive reliable service and (2) that customers will be required to pay for only those costs that the LDC incurred in order to serve them. This Order resolves, for an up to a five year transition period, the questions posed to us by the MGUC, i.e., the disposition of capacity and any associated cost responsibility. The MGUC was acting under Department direction to implement the Department's overall policy goals for a competitive natural gas industry. Those goals are to (1) provide the broadest possible customer choice (2) provide all customers with an opportunity to share in the benefits of increased competition (3) ensure full and fair competition in the gas supply market (4) provide functional separation between sale of gas as a commodity and local distribution service (5) support and further the goals of environmental regulation and (6) rely on incentive regulation where a fully competitive market cannot exist, or does not yet exist.

The Department envisions a fully competitive gas industry in which all customers would have the option to purchase both gas commodity and transportation capacity from a wide range of providers operating in a competitive market. In this fully competitive market for commodity and capacity, LDCs no longer would be required to serve as gas merchants to all customers downstream of the city gate but would be responsible only for the local distribution function. That is, the LDCs' obligations would be limited to the transportation and delivery of supplies brought to the city gate by competitive third-party suppliers in order to serve the LDC's customers.

However, a workably competitive upstream capacity market must exist in order to ensure the availability of reliable and reasonably priced capacity resources without intensive regulatory oversight. The Department believes that the conditions precedent to a fully competitive market structure for interstate pipeline and storage capacity have not yet been fulfilled. Because the upstream capacity market currently is not sufficiently competitive, the LDCs' obligation to serve cannot now be eliminated if the reliability of the system is to be maintained. Therefore, the Department concludes that, in order to ensure reliable gas deliveries at reasonable prices, the LDCs must, for the time being, retain the obligation to plan for and procure capacity resources during a transition period. Barring a significant market reform by the FERC in the interim, the Department believes that a five year transition period, with a three-year evaluation of working conditions, is appropriate. At the end of the first three years of this transition period, the Department will evaluate the level of competition in the upstream capacity market and determine whether the market is sufficiently competitive to warrant lifting or modifying the LDCs' service obligation to acquire capacity. At that time, the Department will consider a number of factors including, but not limited to, the number of transportation customers, the number of marketers, the percentage of the market that has converted to transportation service, and developments at the FERC. This final factor is especially important because actions yet to be taken by the FERC may accelerate or may slow the move towards a more competitive upstream capacity market which, in turn, may influence the availability of future gas supplies in Massachusetts.

For the reasons already stated, the Department concludes that voluntary assignment of upstream capacity currently would be inconsistent with the LDCs' obligation to provide reliable and least cost service and would result in improper cost shifting among customers. In contrast, a mandatory, slice-of-the-system approach to capacity assignment enables migrating customers to gain access to capacity, while maintaining reliability and avoiding improper transfer of cost responsibility. Accordingly, the Department concludes that mandatory capacity assignment is necessary for the initial phase of the transition to a competitive market: it will provide the resources necessary for competitors to commence service to their new customers and will protect customers remaining with the LDC. Additionally, mandatory capacity assignment will provide marketers with the opportunity to gain worthwhile experience in managing capacity contracts before the transition period ends.

With respect to contract renewal and supply planning responsibility, the Department concludes that, to ensure the provision of reliable gas service, at least during the first three years of the transition period, the LDCs must retain their obligation to plan for and procure necessary upstream capacity to serve all firm customers. LDCs will have the responsibility to recontract for capacity on an as-needed basis, subject to the approval of the Department. Once the competitive market for upstream capacity fully develops, the LDCs' role in procuring gas and upstream capacity may be replaced with a marketplace of many alternative providers of capacity, and the LDCs would remain simply in the gas distribution function. At that time, marketers would, on behalf of their customers, plan for and acquire both the commodity and capacity necessary to deliver gas to the LDC's city gate. The LDC would have the final delivery obligation.

Finally, we also approve the concept of a fair, open, and transparent Portfolio Auction for those LDCs voluntarily choosing to use such an approach. The Portfolio Auction enables market participants to gain familiarity with how a future competitive market may work, familiarizes LDCs with that market, and allows marketers experience with the Massachusetts retail market, all before the transition period is over. A Portfolio Auction has the potential to reduce retail prices in the near-term without having an adverse effect on marketplace competition.

VIII. ORDER

Accordingly, after due consideration it is

ORDERED: Bay State Gas Company, the Berkshire Gas Company, Blackstone Gas Company, Boston Gas Company, Colonial Gas Company, Commonwealth Gas Company, Essex County Gas Company, Fall River Gas Company, Fitchburg Gas and Electric Light Company, and North Attleboro Gas Company shall comply with the requirements as set forth in this Order; and it is

FURTHER ORDERED: That the Secretary of the Department shall serve a copy of this Order on all persons appearing on the service list established in this matter.

By Order of the Department,

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Janet Gail Besser, Chair

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James Connelly, Commissioner

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W. Robert Keating, Commissioner

Paul B. Vasington, Commissioner

Eugene J. Sullivan, Jr., Commissioner

1. See list of the nine LDCs at page 2, below.

2. The Bay State Collaborative commenced in April 1997, and concluded in February 1998, when Bay State determined that the parties in its collaborative would be unable to reach a comprehensive settlement.

3. Since the NOI, the Department has approved the unbundled rates of all of the five local distribution companies that were directed by the Department to unbundle rates. The Berkshire Gas Company, D.T.E. 98-65 (1998); Colonial Gas Company, D.T.E. 98-64 (1998); Commonwealth Gas Company, D.T.E. 98-63 (1998); Fitchburg Gas and Electric Light Company, D.T.E. 98-51 (1998); North Attleboro Gas Company, D.T.E. 98-61 (1998). In addition, on November 30, 1998, the Department approved a model of a partial set of terms and conditions for the restructuring of the natural gas industry in Massachusetts. Model Terms and Conditions for the Natural Gas Industry, D.T.E. 98-32-A (1998).

4. On July 29, 1998, the FERC issued a Notice of Proposed Rulemaking ("NOPR"), RM98-10, and a Notice of Inquiry ("NOI"), RM98-12 concerning possible adjustments to its regulation of natural gas. The NOPR focuses on FERC's regulation of short-term transportation services on pipelines. The NOI seeks comments on FERC's regulatory policies for interstate natural gas transportation services as they relate to the long term market, and comments on pricing policies for new capacity.

5. City gate is the point of connection of the interstate pipeline and the LDC's distribution system, where physical possession of the gas commodity is transferred to the LDC by the

pipeline. As gas flows generally from producer to end-user, the city gate is the demarcation point between "upstream" (i.e., interstate pipeline) capacity and "downstream" (i.e., LDC distribution system, including liquified natural gas and propane peaking) capacity.

6. In 1985, the FERC required interstate natural gas pipelines to offer non-discriminatory transportation service for natural gas users. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, F.E.R.C. Stats. & Regs. ¶ 30,665 (1985), modified Order No. 436-A, F.E.R.C. Stats. & Regs. ¶ 30,675 (1985), modified further, Order No. 436-B, III F.E.R.C. Stats. & Regs. ¶ 30,688, reh'g denied, Order No. 436-C, 34 F.E.R.C. ¶ 61,404, reh'g denied, Order No. 436-D, 34 F.E.R.C. ¶ 61,405, reconsideration denied, Order 436-E, 34 F.E.R.C. ¶ 61,403 (1986), vacated and remanded sub. nom., Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987), cert. denied sub. nom., 485 U.S. 1006 (1988). In 1992, the FERC required these pipelines to separate totally, i.e., unbundle, their merchant sales and transportation services. Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, F.E.R.C. Stats. & Regs. ¶ 30,939, order on reh'g, Order No. 636-A, F.E.R.C. Stats. & Regs. ¶ 30,950, order on reh'g, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), reh'g denied, 62 F.E.R.C. ¶ 61,007 (1993), remanded in part, United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996) (hereinafter "FERC Order 636"). FERC Order 636 also permits pipeline customers to resell, i.e., release, unused transportation capacity in a "secondary market," thus offering end-users a wider choice of transportation alternatives.

7. "Migrating customer" refers to an LDC customer who has chosen to acquire the gas commodity from a marketer and, therefore, migrates away from the LDC's traditional bundled (sales and transportation) service to transportation-only service.

8. Bay State is the only LDC favoring an assignment method other than mandatory.

9. The assignment of capacity will be made at FERC maximum rates.

10. For example, recently, transportation on the Tennessee pipeline has been less costly than on Algonquin; and domestic capacity has been less costly than Canadian routes.

11. Bay State supplies gas service to customers in 57 communities. These communities are divided into three separate areas or divisions surrounding Springfield, Brockton, and Lawrence. Bay State Gas Company, D.P.U. 92-111, at 1 (1992).

12. Regarding Bay State's proposal, the Department notes that it is an attempt to bridge the two principal capacity assignment proposals. Although Bay State's proposal addresses, to a certain extent, the Department's reliability concerns, it does not satisfy the Department's goal to move the gas industry to a competitive market without cost shifting. A detailed discussion regarding reliability and cost effects follows in this section.

13. This review could be commenced sooner or later depending on actions taken by the FERC or resulting from other market initiatives.

14. The Department expects that "recall rights" will be part of the comprehensive Model Terms and Conditions filing that will be submitted for our review, after the issuance of this decision. Other safeguards may also be warranted and would, if proposed, be carefully considered.

15. "Default Service" is the sale of gas commodity, transported to the city gate, to a customer who has not selected an alternative supplier. Until the Department directs otherwise, Default Service is the responsibility of the LDCs and will be provided to customers by the LDCs or their designated suppliers, approved by the Department.

16. Of course, the LDCs could choose to not include the costs of past commitments in their prices, forcing their shareholders to forego recovery of those costs, but such an outcome would violate the Department's and the Supreme Judicial Court's findings on ensuring the shareholders the opportunity to recover stranded costs.

17. In order for the LDCs to receive maximum benefits from the release of upstream capacity, they must either release it permanently, or for a multi-month period without recall rights -- because the capacity is of the greatest value to others if available on such a basis.

18. Reliability was not an issue (as it is with voluntary assignment) because the LDCs were required to assume all of the capacity contracts held on their behalf. FERC Order 636. The LDCs were not permitted to choose a lesser amount of capacity, such as has been proposed by the marketers in the instant proceeding.

19. Under the "slice-of-system" approach customers receive their pro rata share of each capacity contract. As a result migrating and remaining customers assume identical capacity costs. Under the "path" approach, customers migrating to transportation early, will have the opportunity to select the least expensive capacity, while customers who select to remain with the LDC's bundled service, will be burdened with the less desirable and more expensive capacity.

20. See footnote 21, below.

21. The Department recognizes that LDCs will soon face a decision whether to renew their Tennessee capacity contracts. The Department's observation here should not be construed as suggesting that the LDCs renew these contracts only at their peril, for the LDCs continue to operate under an obligation to serve. Even-handed regulatory policy cannot impose a present service obligation that necessarily entails prudent contractual commitments and consequent cost responsibility to gas producers, while at the same time suggesting future regulatory shifts could leave LDCs at risk for prudent actions. We expressly disavow so mixed and contradictory a regulatory signal. Fairness requires

recognition of an opportunity to recover costs prudently incurred to meet regulatory obligations. The burden of proving prudence lies, of course, with the LDCs.

22. It remains, of course, possible that the FERC may take, during this period, some action that permits acceleration toward retail competition for gas. If so, an earlier Department review could occur.

23. According to the LDCs a successful bidder must be able to offer default service at a price lower than would otherwise have been offered by the LDC had it continued to provide default sales service through its own management of the upstream assets (MGUC Report, Att. D at 5).

24. Market power, as defined by Bay State, results from the concentration of portfolio holdings by a single asset manager in a relevant market area (Bay State Final Comments at 42).

25. The term "mitigation pool" was not formally defined by the Marketer Group in the context of the Portfolio Auction process. The Department infers that the Marketer Group intended the term "mitigation pool" to mean the aggregate of capacity not elected by customers under a voluntary system.

26. A potential barrier to entry for retail marketers, as identified by the Customer Group, is that a portfolio auction approach under mandatory capacity would assign small capacity volumes under multiple contracts and pipelines to migrating customers (Customer Group Comments at 10).

27. El Paso contends that the permanent assignment of capacity (both to retail and wholesale marketers) will optimize the value potential in that it enables marketers to change the upstream delivery points in the upstream transportation contracts (id. at 4).

28. The LDCs contend that the wholesale marketers, because of their participation in national energy markets and their ability to use financial risk management tools, are best suited to achieving economic efficiencies that will yield lower prices for all customers in the Portfolio Auction process (MGUC Report Att. D at 2).

29. The LDCs contend that both migrating and non-migrating customers would benefit because, in addition to the lower price for default service, competitive suppliers serving transportation customers would face market-pricing pressures from this lower-priced default service (MGUC Report Att. D at 5).